

Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Roger Farmer, Revenue Agent
San Diego

from: Karen Sommers, Attorney
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subject: [REDACTED]

Definition of "tort" liability under I.R.C.
§ 172(f)(1)(B)(ii)

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Via a memorandum dated September 22, 1999, Revenue Agent Roger Farmer requested that this office provide general guidance on the meaning of "tort" in I.R.C. § 172(f), which permits a 10-year net operating loss carryback with respect to specified liability losses.

Prior to its amendment in 1998 section 172(f)(1)(B) treated as a specified liability loss the portion of a net operating loss (NOL) generated by:

(B) any amount [other than product liability expenses and certain expenses related thereto] allowable as a deduction under [Chapter 1 of the Internal Revenue Code] with respect to a liability which arises under a federal or state law or out of any tort of the taxpayer if --

(i) in the case of a liability arising out of a federal or state law, the act (or failure to act) giving rise to such liability occurs at least 3 years before the beginning of the taxable year, or

(ii) in the case of a liability arising out of a tort, such liability arises out of a series of actions (or failures to act) over an extended period of time a substantial portion of which occurs at least 3 years before the beginning of the taxable year.

For this purpose a liability is not taken into account unless the taxpayer used an accrual accounting method throughout the period or periods during which the acts or failures to act giving rise to the liability occurred.

A tort is usually defined as a civil wrong, other than for breach of contract, for which the legal remedy of damages is available. 5 B. Witkin, Summary of California Law, § 3 (1988).

The only decided case to discuss the meaning of "tort" under § 172(f) is Sealy Corp. v. Commissioner, 107 T.C. 177 (1996), aff'd, 171 F.2d 655 (9th Cir. 1999). In Sealy, the Tax Court concluded that Congress intended the 10-year carryback rule to apply to a narrow class of liabilities. 107 T.C. at 186. While Sealy did not directly concern a tort payment covered by § 172(f), the principle of narrow construction enunciated in that case applies to the analysis of subsection 172(f)(1)(B)(ii) as well.

This conclusion is further supported by the fact that the legislative history contains only one, narrowly drawn example of a qualifying liability. The only example given is contained in the House and Senate Reports and involves a situation where a taxpayer incurs a tort liability for failing to protect another person from a hazardous substance, such as chemical waste, over

an extended period of time. H.R. Rep. No. 432 (Part 2) 98th Cong., 2d Sess. 1256 (1984). Congress' use of a single example of limited application to illustrate the scope of section 172(f)(1)(B) demonstrates that Congress viewed this provision as a limited exception to the normal carryback rule.

The line of cases under I.R.C. § 104(a)(2), which excludes personal injury tort damages from gross income, provides some guidance in defining a tort. Section 104(a)(2) excludes only damages received on account of the prosecution of tort or tort type claims, not the prosecution or settlement of economic rights arising out of a contract. Commissioner v. Schleier, 515 U.S. 323 (1995). The cases under § 104(a)(2) generally illustrate that there is no bright line test for determining whether a liability arises from a tort, but that the courts look to many factors to determine the nature of the damages awarded or settlement payment in question.

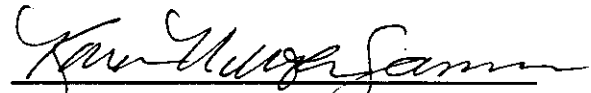
The primary inquiry is whether the action or claim is based upon a right for which "a broad range of damages to compensate the plaintiff" is available. Commissioner v. Schleier, 515 U.S. at 335. This broad range of damages goes beyond merely compensating for disappointed economic expectations arising from a contractual or business (quasi-contractual) relationship.

Where a liability is paid pursuant to a judgment after trial, the judgment itself will presumably set forth the particulars of each injury and legal right for which damages are awarded. In the case of a settlement out of court, "[T]he critical question is, in lieu of what was the settlement paid." Bagley v. Commissioner, 105 T.C. 396, 406 (1995). To answer that question, courts have looked to the intent of the payor, as evidenced by the written settlement agreement. However, other factors may also be considered, such as the underlying complaint if one was filed, and the evidence submitted to the payor in support of the claim. And, where the parties have settled their claims and are therefore no longer adversaries, a subsequent court order which allocates agreed damages to tort liabilities is not controlling. Kightlinger v. Commissioner, T.C. Memo 1998-357.

The narrow scope of the relief provided by Congress from the normal loss carryback provisions in § 172(f) requires careful scrutiny by the Service of taxpayer claims that payments are for torts covered by the specified liability loss definitions. Furthermore, this inquiry must necessarily be connected with the inquiry as to whether the liability arose from a series of

actions or failures to act over an extended period of time a substantial period of which occurred at least three years prior to the taxable year in issue. See § 172(f)(1)(B)(ii). "Single act" torts are not covered by the statute. Even if a taxpayer were able to establish that a particular liability arose from a tort claim, it must then provide proof that the liability arose out of a series of action over an extended period of time. This extended period of time is presumably several years; the National Office has recently indicated that acts over a period of less than two years will not qualify for § 172(f) treatment.

Please consult with this office concerning the particular facts of any claimed tort liability under § 172(f). If you have any questions with respect to this memorandum, please contact me at 557-6014.


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